

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

NEW ENGLAND CARPENTERS HEALTH
BENEFITS FUND; PIRELLI ARMSTRONG
RETIREE MEDICAL BENEFITS TRUST;
TEAMSTERS HEALTH & WELFARE FUND OF
PHILADELPHIA AND VICINITY;
PHILADELPHIA FEDERATION OF TEACHERS
HEALTH AND WELFARE FUND; DISTRICT
COUNCIL 37, AFSCME - HEALTH &
SECURITY PLAN; JUNE SWAN; MAUREEN
COWIE and BERNARD GORTER,

Plaintiffs,

v.

FIRST DATABANK, INC., a Missouri corporation,
and McKESSON CORPORATION, a Delaware
corporation,

Defendants.

Civil Action: 1:05-CV-11148-PBS

Judge Patti B. Saris

**MCKESSON CORPORATION'S SECOND SUPPLEMENT OF THE
CLASS CERTIFICATION RECORD**

[REDACTED VERSION]

Pursuant to the Court's instruction at the May 22 class certification hearing, McKesson hereby updates its supplement of the class certification record. This filing presents evidence developed since McKesson's July 12, 2007 submission, showing widespread knowledge of the FDB spread increases, and contractual modifications that offset the financial impact of the FDB markup increases.

I. ADDITIONAL EVIDENCE FURTHER CONFIRMS THAT IN APRIL 2002 ESI

- Express Scripts, Inc. testified that the April 2002 "ESI Letter" [REDACTED] (Kiefer Dep. 53:11-55:19, July 24, 2007, attached as Ex. 1; emphasis added), and that it [REDACTED] (*Id.* 186:21-189:23.) ESI is one of the three largest PBMs in the United States. (Kiefer Dep. 26:13-22.)
- ESI testified that the April 2002 letter was distributed through its Emerging Therapeutic Issues program, such that [REDACTED] (Kiefer Dep. 186:21-187:22.)
- This newly obtained evidence further refutes Plaintiffs' and Dr. Hartman's claims that PBMs did not advise their payor clients of the FDB increases, and that ESI's April 2002 letter was sent to very few TPPs.¹

II. ADDITIONAL EVIDENCE FURTHER CONFIRMS THAT MANY TPPS DISCOVERED THE FDB MARKUP INCREASES ON THEIR OWN.

- ESI testified that [REDACTED] (Kiefer Dep. 59:21-61:20), and that managed care clients [REDACTED] (*Id.* 176:4-22.)
- Blue Shield of California testified that [REDACTED] (Stalker Dep. 69:3-76:2, July 17, 2007, attached as Ex. 2.)
- This newly discovered evidence further refutes Plaintiffs' claim that the class was uniformly ignorant of FDB's spread increases.

¹ Although Plaintiffs continue to insist that a class member must have had full knowledge of "the Scheme" to respond to the spread increases, the Court has observed that knowledge of the alleged "Scheme" is not the issue. If class members knew about the spread increases and took actions to recoup any impact—[REDACTED]—then the defendants are not liable to those class members.

III. ADDITIONAL EVIDENCE FURTHER CONFIRMS THAT TPPS RECEIVED FULL RECOUPMENT.

- ESI testified that [REDACTED] (Kiefer Dep. 216:14-219:4; 177:6-178:18; 233:21-236:15), and that [REDACTED] (*Id.* 85:7-91:2.) (emphasis added.)
- ESI testified that in renegotiating and renewing contracts with its clients, [REDACTED] (Kiefer Dep. 94:15-95:4; 118:13-119:4; 119:8-18; 133:3-8; 155:23-156:10.)
- ESI testified that the reason [REDACTED] (Kiefer Dep. 219:24-222:22; 226:20-229:10.) This new testimony conforms precisely with Dr. Berndt's theory of economic behavior in the PBM industry.
- In a conference call that Medco hosted, its CFO reported that "[d]ue to the highly competitive nature of this business, any incremental value that may have occurred as a result of the First DataBank changes to AWP have been passed on to the payers [through] pricing improvements from new contracts and renewals." (Haertel Decl., Ex. A at 5, attached as Ex. 3.)
- Medco reported that "[s]ince 2001," its clients "have benefited by additional discounts and rebate sharing specifically on brand products that on average have resulted [in] over 400 basis points [4%] of savings." (*Id.*)
- This new evidence further contradicts Plaintiffs' position that no TPPs were able to recoup past damages, and shows that individual issues regarding the impact of the FDB markup increases predominate with respect to both liability and damages.²

IV. ADDITIONAL EVIDENCE FURTHER DEMONSTRATES WHY MANAGEABILITY PROBLEMS NEGATE CLASS CERTIFICATION.

- ESI's testimony shows that its clients were not "locked into" contracts. Some contracts were renegotiated midterm, and the others were renewed and renegotiated on a staggered basis. ESI testified that [REDACTED] (Kiefer Dep. 76:18-78:20; 134:16-137:11.)

² McKesson submitted a declaration from Caremark in opposition to class certification (McKesson Class Opp'n, Schechter Decl., Ex. 4A), and is submitting a Medco declaration herewith. McKesson submitted these declarations in lieu of deposition testimony to streamline its discovery.

- ESI testified that the prospect of analyzing its entire client list **to determine which among them had not received full recoupment** would be [REDACTED]
(Kiefer Dep. 230:4-231:4; emphasis added.)
- Since claims of consumer class members are derivative of the claims of their respective TPPs, all of the same individual issues predominate. As Blue Shield's deposition shows, the consumer class presents even more individual issues, [REDACTED]
(Stalker Dep. 27:17-28:16.)
(Id. 34:22-37:1.)

Respectfully submitted,

McKesson Corporation
By its attorneys:

/s/ Paul Flum

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Dated: August 1, 2007

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the above document was served upon the attorney of record for each other party through the Court's electronic filing service on August 1, 2007.

/s/ Paul Flum

Paul Flum

Exhibit 1

Filed Under Seal

Exhibit 2

Filed Under Seal

Exhibit 3

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BENEFITS FUND; PIRELLI ARMSTRONG
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DECLARATION OF VALERIE HAERTEL

I, **Valerie Haertel**, declare as follows:

1. I am the **Vice President of Investor Relations** at Medco Health Solutions, Inc. (“Medco”) and have held this position since **October 2, 2006**. I am familiar with the facts set forth in this declaration based on my personal knowledge.

2. Medco is a pharmacy benefit management (“PBM”) company that, among other things, purchases or reimburses purchases of drugs from pharmacies on behalf of Medco’s clients, which include third party payors of prescription drug benefits (“TPPs”) such as health maintenance organizations, managed care organizations, insurance companies, employers, and labor unions.

3. On November 3, 2006, Medco Health Solutions hosted a conference call with investors and analysts to discuss Medco's third quarter 2006 earnings. Medco's Chief Financial Officer, JoAnn Reed, spoke during this conference call.

4. Medco did not prepare a transcript of the call.

5. A third party prepared a transcript of the call. I obtained a copy of that transcript from Thompson Financial.

6. Attached as Exhibit A is a true and correct copy of that transcript of the November 3, 2006 conference call.


I declare under penalty of perjury that the foregoing is true and correct.

Dated: July 31, 2007


Valerie Haertel

State of New Jersey:
County of Bergen:

Sworn and subscribed
before me on July 31, 2007.


JOAN C. MARRI
Notary Public of New Jersey
My Commission Expires Dec. 21, 2010

FINAL TRANSCRIPT

Thomson StreetEventsSM

MHS - Q3 2006 Medco Health Solutions Earnings Conference Call

Event Date/Time: Nov. 03. 2006 / 8:30AM ET

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Nov. 03. 2006 / 8:30AM, MHS - Q3 2006 Medco Health Solutions Earnings Conference Call

CORPORATE PARTICIPANTS**Valerie Haertel***Medco Health Solutions - VP of IR***Dave Snow***Medco Health Solutions - Chairman and CEO***JoAnn Reed***Medco Health Solutions - SVP, CFO***Tim Wentworth***Medco Health Solutions - CEO of Accredo***David Machlowitz***Medco Health Solutions - General Counsel***CONFERENCE CALL PARTICIPANTS****Ricky Goldwasser***UBS - Analyst***Charles Boorady***Citigroup - Analyst***Lisa Gill***JPMorgan - Analyst***Larry Marsh***Lehman Brothers - Analyst***Tom Gallucci***Merrill Lynch - Analyst***Glen Santangelo***Credit Suisse - Analyst***Christopher McFadden***Goldman Sachs - Analyst***Robert Willoughby***Banc of American Securities - Analyst***Andy Speller***A.G. Edwards - Analyst***Mike Maguire***FTN Midwest - Analyst***Michael Baker***Raymond James - Analyst***PRESENTATION****Operator**

Good morning; my name is Wes and I will be your conference operator today. At this time I would like to welcome everyone to the Medco Health Solutions third-quarter 2006 earnings conference call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks there will be a question-and-answer session. (OPERATOR INSTRUCTIONS). I would now like to turn the conference over to Miss Valerie Haertel.

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Valerie Haertel - Medco Health Solutions - VP of IR

Good morning, everyone, and thank you for joining us on today's call. I'm Valerie Haertel, Vice President of Investor Relations for Medco. Joining me today are Dave Snow, Chairman and Chief Executive Officer, and JoAnn Reed, Chief Financial Officer. Also joining us today for the Q&A are Medco President and COO, Kenny Klepper; our General Counsel, David Machlowitz; and CEO of Accredo, Tim Wentworth.

Please note that if you have not yet received a copy of our earnings release, it is available on the Investor Relations section of our website at Medco.com. Today we will begin with remarks by Dave Snow and JoAnn Reed. In light of SEC Regulation FD, management will be limited in responding to inquiries from investors and analysts in a nonpublic forum. Therefore we encourage you to ask all questions of a material nature on this call.

During the course of this call we will make forward-looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995. These statements involve risks and uncertainties that may cause results to differ materially from those set forth in the statements. No forward-looking statement can be guaranteed and actual results may differ materially from those projected. We undertake no obligation to publicly update any forward-looking statement whether as a result of new information, future events or otherwise.

Forward-looking statements made on this call should be evaluated together with the risks and uncertainties that affect our business, particularly those disclosed in the risk factor section of the Company's annual report on Form 10-K and other reports and registration statements filed from time to time with the Securities and Exchange Commission. Copies of Medco's filings are available from the SEC, the Medco website or from the Medco Investor Relations department. The copyright for the contents of this discussion and the written materials used on this earnings call are owned by Medco Health Solutions (technical difficulty). At this time I would like to turn the call over to Dave Snow. Dave?

Dave Snow - Medco Health Solutions - Chairman and CEO

Is there a reason the phone is buzzing? I guess not. Okay. Thanks, Valerie, and good morning to everybody. I'd like to formally welcome Valerie Haertel to our team as our new Vice President of Investor Relations. Valerie comes to us after five years at Alliance Bernstein where she was Vice President and Director of Investor relations. I know that Valerie's breadth of knowledge and experience will be a great benefit to Medco and to our shareholders and I hope that you'll take the opportunity to meet her in person at our analyst day on November 30th.

We have a lot to cover today starting with our third-quarter financial results and highlights followed by a discussion of our earnings expectations for the remainder of 2006 and 2007. Then I will provide some context to the Wal-Mart generic and AWP matters that have generated confusion in the investment community. This recent news does not pose a significant risk to Medco and both JoAnn and I will explain why in detail. You can see from our increased guidance for 2006 and our new 2007 guidance that we do not expect any material impact from these news issues. After my remarks JoAnn will also discuss our financial results in greater detail. In addition, we can address the recent announcement concerning our competitor during Q&A.

This was a strong quarter for Medco reflecting continued success driven by net new sales, record high generic utilization; record high EBITDA per adjusted scrip, progress at Accredo, steady growth at mail and progress with our Medicare offering. Third-quarter financial highlights include net revenues of \$10.5 billion, up 12% from the third quarter of 2005; net income for the quarter of nearly \$186 million, up 18.6% from the third quarter of 2005; GAAP EPS for the third quarter of \$0.62 compared to \$0.53 in the same quarter last year.

Excluding the amortization of intangibles that existed when Medco was spun-off in 2003, third-quarter EPS was \$0.71 compared to \$0.62 in the third quarter of 2005. On a pro forma basis incorporating stock option expense for 2005 diluted EPS grew 29% from \$0.48 in the third quarter of 2005 to \$0.62 in the third quarter of 2006. On this same pro forma basis excluding the income

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tax benefits for the third quarters of both 2005 and 2006, diluted earnings per share growth was approximately 54%. Third-quarter 2006 EPS reflects a benefit of \$0.02 per share from a favorable tax ruling, while the third quarter of 2005 reflects a benefit of \$0.09 per share from state income tax law changes and other tax items. EBITDA per adjusted script reached \$2.30, another record high, up 25.7% from \$1.83 in the third quarter of 2005 and up 7% sequentially from \$2.15 in the second quarter of 2006.

Today Medco announced an expansion of the share repurchase plan by an incremental \$1 billion bringing the plan to a cumulative total of \$2.5 billion. During the quarter Medco repurchased more than 1.2 million shares for \$71.8 million. Since the inception of the program in August 2005 we have repurchased 22.8 million shares valued at \$1.2 billion through the third quarter of 2006.

Now I'd like to review the results for the quarter within the framework of the five strategic growth drivers that we have previously outlined for 2006. First, generic utilization increased strongly across our book of business; this was driven first by patent expirations for three blockbuster drugs -- Zocor, Zoloft and Mobic combined with the unexpected though perhaps short-term generic availability for the blockbuster blood thinning drug, Plavix.

Our generic dispensing rate for the third quarter reached a record high of 56%, up 4.5 percentage points from last year's third quarter and up 2.1 percentage points sequentially from last quarter. Brand drug patent expirations are expected to total approximately \$45 billion for the period 2006 through 2010, which will result in significant overall savings for our clients and members especially those that utilize our mail-order service. Our mail penetration rate this quarter was 37.1% on an adjusted scrip basis, the highest in the industry, reconfirming Medco as the nation's leading mail-order pharmacy for chronic maintenance medications.

Last month, after 18 months of development and regulatory approvals and in cooperation with Nationwide Insurance, Medco launched a new insured prescription drug program named Generics First. This product was developed to address a niche segment of the market that Medco did not serve previously -- the small group uninsured and underinsured market making prescription medications available at low cost for small employers who may otherwise offer little or no prescription coverage for their employees; or midsize employers with a larger population of transient or part-time workers. This product is almost exclusively geared to generic dispensing at mail. Generics First is already available in 32 states and is the broadest solution of its kind encompassing more than 800 generic drugs and more than 2,000 NDCs.

Turning to sales. New annualized sales for 2006 increased 16% to \$3.7 billion from \$3.2 billion in 2005. Looking ahead to 2007 we have already won more than \$1.2 billion in annualized new sales for 2007, up over 30% from the second quarter. Year-to-date net new business for 2006 is \$3.3 billion, \$300 million less than we reported in the second quarter. This quarter-over-quarter decline primarily reflects changes in estimates for drug spend among certain clients and, to a lesser extent, from account turnover.

Through the third quarter we have successfully renewed \$6.3 billion of our book of business for 2006, essentially all of our outstanding 2006 renewals. Additionally for 2007 we have renewed over \$6.9 billion to date or nearly 70% of our book up for renewal, indicating another \$1.6 billion in progress since our second-quarter call.

Let me turn now to our specialty pharmacy business. Accredo Health Group is the nation's largest provider, an important strategic asset to us. In the third quarter we continued to see growth in the previously announced new restricted distribution drugs and in Accredo's penetration of Medco's book of business which was somewhat offset by the effect of several clients who brought specialty pharmacy capabilities in-house. Gross margins were 7.6% on revenue that grew to nearly \$1.4 billion.

I would also note that in 2006 Accredo has been a net new winner of lives between patient assistance programs and Medicare Part D. It is also important to note that we have a large and increasing number of clients working with us to ensure their members are directed to Accredo as their preferred specialty pharmacy alternative. Our clients' decisions to shift to a more narrow specialty distribution network is important as it drives more volume directly through Accredo and helps deliver incremental value to our clients.

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Today Medco has more than 42 million lives eligible to receive specialty pharmacy products and services through Accredo. For 2006 we maintain earlier expectations that Accredo Health Group will contribute an incremental \$0.06 to \$0.08 per share. Tim Wentworth, Accredo Health Group's CEO, will discuss Accredo 2006 performance and 2007 strategic plans during Medco's analyst day on November 30th.

Moving on to our progress with Medicare Part D, we announced in September that Medco, through our PDP YOURx PLAN, was one of the 17 national providers approved to offer Medicare prescription drug plans for the 2007 plan year to all 34 regions and Puerto Rico. For 2006 we have experienced continued growth with 1.3 million Medicare Part D members to date, up from 1.2 million in the second quarter. As a result we have narrowed our incremental 2006 contribution to \$0.04 per share, the upper end of our previously disclosed range of \$0.02 to \$0.04.

Based upon our strong quarterly results we are raising our 2006 earnings per share guidance and narrowing the range we provided last quarter to \$2.33 to \$2.36, excluding the effect of the onetime \$0.33 a share for a legal settlements charge taken in the first quarter 2006. This is up from the \$2.26 to \$2.35 range we discussed with you in August, representing growth of 27 to 28% over pro forma 2005 EPS including stock option expense.

For the full year 2007 Medco expects to achieve GAAP diluted earnings per share in the range of \$2.76 to \$2.83 representing growth of 17 to 21% over the revised 2006 guidance excluding the onetime legal settlements charge. This translates into expected diluted earnings per share in the range of \$3.12 to \$3.19 excluding the effect of amortization of intangibles related to our 2003 spin-off. On this basis and excluding the effect of the onetime legal settlements charge taken in the first quarter of 2006, we expect 2007 earnings per share growth to be in the range of 15 to 19% over the revised 2006 guidance.

JoAnn will elaborate on both 2006 and 2007 guidance shortly. Before we turn to the industry issues I'd like to take a moment to mention how pleased we are to have been able to finalize a legal settlement to the so-called Sheehan litigation that has been outstanding for seven years. In fact, this settlement affectively closes the book on three previously disclosed inquiries by the U.S. attorney's office for the Eastern District of Pennsylvania. Although Medco did nothing wrong, settling these matters was the right business decision for our company and our clients.

As a provision of that settlement, on October 23rd Medco entered into a five-year corporate integrity agreement with the Department of Health and Human Services and the Office of Personnel Management to formalize policies and processes to ensure the Company's compliance with mutually agreed-upon standards of practice. Such agreements are typical in settlements of this type that involve programs for which HHS provides oversight.

Turning now to industry news -- I will first address Wal-Mart's move to offer 30-day or less retail generic prescriptions at a price of \$4.00. We applaud Wal-Mart's efforts to focus consumers on the value of generic drugs and we do not believe this move will harm Medco. It is clear that this is a marketing strategy designed to shift foot traffic from other retailers into their stores. Wal-Mart's program is limited to 143 medicines; primarily older, already low-cost generics which represent less than 5% of overall drug spend.

This retail to consumer product would be appealing to those who don't have access to the massive group purchasing advantages of a company like Medco, namely the uninsured and those who have entered into the Medicare Part D donut hole and who happen to utilize drugs that appear on Wal-Mart's limited list. This competition is good for our members, good for our payers and we have not seen any material impact to our mail-order volume or margins. JoAnn will provide a few data points in her remarks.

The issue causing the most confusion for investors in our industry this quarter has been the proposed settlement in the case of First DataBank related to average wholesale price more commonly known as AWP. I would like to make the following points that clarify why this proposed settlement by First DataBank does not have any material effect on Medco's short-term or long-term profitability.

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Before I discuss the potential implications to Medco and its clients specifically I want to state that Medco is not a party to this case. Like others in our industry, we sought a standard benchmark to enable clients to compare the competitive nature of discounts in the bid process. And First DataBank, considered in this industry the leading provider of AWP pricing data, has been Medco's provider of this data for over 20 years.

Now let me discuss the potential implications for Medco specifically. It appears that Medco is uniquely well prepared among the individual PBMs for this occurrence. Beginning early in 2001 Medco began adding contractual language to our renewal and new business contracts that keep the economic relationship between ourselves and our clients' net neutral in the event of a pricing methodology change such as the one recently proposed. The good news for Medco is that the vast majority of our clients include this explicit language which protects Medco and our clients from uncertainty when there are changes to the benchmark or methodology.

The proposed FDB settlement does not change the economics of our drug purchasing, nor does it change the underlying value we guarantee our clients. In a purely hypothetical example using round numbers, if a client is contracted to pay AWP minus 25% for brand drugs and the AWP price is \$100, they will pay \$75 in ingredient costs. If, after the settlement, this \$100 drug is reduced to a new AWP benchmark price of \$96 the client will still pay \$75 in ingredient costs, thus the discount will be modified to reflect the new relationship between AWP and our unchanged ingredient cost.

Since news of this proposed settlement I have spoken personally with over 150 clients individually and in groups. I have also spoken to members of the consulting community. They understand what AWP is and they understand the intention that both partners should be kept whole relative to the agreed-upon economics. In summary, we believe that regardless of the outcome of this settlement there will be no meaningful impact to our margins across our book of business as is evidenced in our 2007 guidance today.

Now to further elaborate on these two -- on these latest matters, our third-quarter financial results and our 2006 and 2007 guidance, I'll turn the call over to Medco's CFO, JoAnn Reed.

JoAnn Reed - Medco Health Solutions - SVP, CFO

Thank you, Dave. Good morning, everyone. I'd like to add to Dave's commentary surrounding the potential changes to AWP pricing as it relates to Medco. Should this be settled as proposed, we would expect the impact on Medco's bottom-line to be immaterial. Including the current renewals in progress, Medco will have over 93% of its drug spend covered by the contractual provision that holds both parties neutral to methodology or pricing benchmark changes. By the time of implementation, if it occurs, we would expect to have a similar contractual provision in place with the majority of our clients.

The AWP benchmark increases that occurred post 2001 appear to have been gradual, over more than a year's time, and were not across the board. Due to the highly competitive nature of this business, any incremental value that may have occurred as a result of the First DataBank changes to AWP have been passed on to the payers and pricing improvements from new contracts and renewals. Since 2001 and our clients have benefited by additional discounts and rebate sharing specifically on brand products that on average have resulted an over 400 basis points of savings.

Now let me turn to the Wal-Mart issue. Of the 143 drugs that are available under the Wal-Mart program, Medco dispensed approximately 5,900 prescriptions to the Tampa area over the last ten weeks. These Rx's accounted for less than 5% of the drug spend in the Tampa area and our mail share for these drugs remained constant over this ten week period. Therefore there was no material impact to our mail margin. Also, our clients and members benefited from the program since our typical retail pricing is the lower of the discounted AWP price max price or the usual and customary charge.

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Now let me turn to the financial results for the third quarter. As you can see from our strong financial results today, our expanded share repurchase authorization and our continued strong expectations for 2007, we remain focused on driving shareholder value. Third-quarter 2006 net revenues increased 12.2% to \$10.5 billion compared to \$9.3 billion in the third quarter of 2005.

The increase is related to a combination of factors -- \$500 million in incremental specialty revenue from Accredo Health Inc. for a full quarter compared to a five-week period in the third quarter of 2005; higher net client volume for new business and brand-name drug inflation partially offset by previously announced customer losses; increased levels of rebate sharing and a \$530 million reduction from the effect of lower-cost generic drugs.

Medco achieved record level generic dispensing rates this quarter which I will address shortly. Total prescription volume in the third quarter of 2006, adjusting for the difference in days supply between mail and retail increased to \$179.2 million from \$173.4 million in the third quarter of 2005 as a result of higher volumes primarily from new clients. We dispensed 22.3 million prescriptions through our mail-order pharmacies in the third quarter, an increase of 900,000 prescriptions compared to the third quarter of last year. Retail prescription volume increased 3.2% in the quarter to 112.7 million.

As I noted last quarter, Medco's past third-quarter results have typically reflected lower retail prescription volume with a seasonal mix more heavily weighed towards lower rebated brand-name drugs such as antibiotics and antihistamines, and lower volume of higher rebated drugs. We did experience the typical seasonality affect for the third-quarter retail claims and we saw a higher volume of new brand product introductions which have relatively lower rebate levels.

Adjusted mail prescriptions as a percentage of the total increased 10 basis points to 37.1% from 37% in the same period last year. Total product net revenues in the quarter were \$10.3 billion, an increase of approximately \$1.1 billion or 12% when compared to the third quarter of 2005. Product net revenues consisted of \$6.3 billion in retail revenues and \$4 billion in mail revenue.

Total service revenues in the quarter were \$126.3 million, an increase of \$24.6 million or 24.2% compared to the same period last year. Service revenues include \$85 million of client and other service revenues and \$41.3 million of manufacturer service revenue. Client and other service revenues increased \$25.8 million or 43.6% as a result of fees from our Medicare Part D products and clinical programs including administrative fees associated with higher client rebate sharing.

Third-quarter overall gross margin increased 70 basis points to 5.7% compared to 5% in the same quarter of 2005 and increased 20 basis points from the 5.5% reported in the second quarter of 2006. The 5.7% third-quarter margin is comprised of 4.8% product margin and 78.8% service margin. The margin increase from the third quarter of 2005 is primarily due to the increase in generic dispensing rates, the inclusion of a full quarter of Accredo Health Inc. results in the third quarter of 2006, and higher service margins partially offset by a decrease in the rebate retention rate.

The overall generic dispensing rate for the third quarter of 2006 was a record 56%, up 4.5 percentage points when compared to the same period last year. Generic dispensing rates have now reached 46.3%, up 4.7 percentage points from the third quarter of 2005. Generic dispensing rates at retail rose to 57.9%, up 4.4 percentage points from the prior year.

Total rebates earned in the quarter were \$808 million, down slightly from \$814 million in the third quarter 2005 reflecting brand-name drugs that have recently lost patent protection. The total amount of rebates retained in the quarter was 18.3%, down from 25.8% a year ago and down from 21.2% in the second quarter 2006. The decline in rebates retained reflects changes in client rebate sharing terms associated with a significant volume of renewals and new business wins. As we have indicated in the past, clients who choose contracting terms with higher rebate sharing generally receive lower discount levels or are charged higher administrative fees reflected in the service revenues that I explained earlier.

Turning now to our specialty pharmacy business -- revenues were nearly \$1.4 billion for the quarter which includes nearly \$13 million in service revenues. Operating income decreased 11.4% to \$44.2 million compared to \$49.9 million in the prior quarter. Gross margins were 7.6%, a decrease of 70 basis points from 8.3% in the second quarter of 2006. The decrease is primarily due

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to the mix of drugs dispensed in the quarter with lower volume from higher margin products and higher volume from lower margin products.

Accredo Health Group results contributed \$0.01 this quarter, bringing year-to-date contributions to \$0.05. We continue to expect \$0.06 to \$0.08 contribution to full-year 2006 earnings per share for Accredo Health Group. We currently have over 42 million members eligible to receive Accredo specialty pharmacy benefits.

Third-quarter Medicare expenses for start-up costs such as enrollment-related activities amounted to \$3 million. Of this \$1.6 million was recorded in cost of service revenues and \$1.4 million in SG&A. Once again we see a meaningful utilization trend for the Medicare Part D population in terms of mail and generics. Mail penetration has grown to over 11%, well above our initial annual expectation of 5%. We have been able to achieve this result despite mail penetration among the auto assigned dual eligible population of less than 1%. Excluding the dual eligibles we expect about 36% mail penetration for our PDP for 2007.

The generic dispensing rate for our Medicare Part D members at 59% is above our annual expectation of 50% for 2006. Both of these statistics serve to reinforce our conviction that the nation's seniors are very savvy buyers and are not hesitant to use mail and generics if it means getting the same result at a lower cost.

As Dave mentioned, we have narrowed 2006 expectations for Medicare Part D to \$0.04 per share, the upper end of our previously disclosed range of \$0.02 to \$0.04 per share. SG&A expenses amounted to \$222.9 million in the third quarter, an increase of 19.6% or \$36.5 million when compared to the third quarter of 2005. This increase primarily reflects incremental Accredo expenses of \$27 million recognizing that we have Accredo for five weeks in the third quarter of 2005 and the effect of stock option expensing which amounted to \$12 million.

Interest and other expense net amounted to \$20.9 million, an increase of \$10.3 million from the third quarter of 2005 due to the additional average debt related to the Accredo acquisition, higher interest rates and increased short-term borrowing levels in the third quarter of 2006.

EBITDA in the quarter amounted to \$412.9 million, an increase of 30.2%, or \$95.8 million compared to the third quarter of 2005. The increase reflects the higher generic dispensing rate, higher Accredo Health Group margins, higher service margins and new business contributions. Our EBITDA per adjusted prescription for the quarter was a record \$2.30, a 25.7% increase over the \$1.83 in the third quarter of 2005, and a 7% increase from the second quarter of 2006, reflecting the overall strong financial and operational performance of the Company.

The tax rate for the third quarter was 37% and 37.6% on a year-to-date basis. These rates reflect favorable items recorded in the third quarter of 2006 including the effect of a ruling from the Internal Revenue Service that reduced our provision for income taxes resulting in a favorable impact of \$0.02 per share. The third quarter of 2005 reflected a benefit of \$0.09 per share from state income tax law changes and other tax items. The tax benefit is the only item of a non-recurring nature that will be highlighted in our 10-Q which will be filed later today.

GAAP net income in the third quarter was \$185.8 million, an increase of \$29.1 million or 18.6% when compared to the \$156.7 million in the third quarter of 2005. Third-quarter GAAP diluted earnings per share was \$0.62, an increase of 17% or \$0.09 compared to the third quarter of 2005. Excluding \$0.09 per share in amortization of intangible assets that existed when Medco became a publicly traded company, EPS was \$0.71.

Due to the Accredo acquisition and stock option related activity partially offset by share repurchases, our diluted weighted average shares outstanding increased from 296.5 million in the third quarter of 2005 to 298.7 million in the third quarter of 2006. We recorded pretax stock option expense of \$14.8 million in the third quarter of 2006, \$2.5 million of which was recorded in cost of product revenues and \$12.3 million of which was recorded in SG&A. The third-quarter 2007 -- 2005 pro forma equivalent stock option expense amounted to \$23.7 million in total on a pretax basis.

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Now turning to the balance sheet. We closed the third quarter of 2006 with over \$450 million in cash on the balance sheet compared to \$1.3 billion at the end of the third quarter of 2005, and over \$400 million at the end of the second quarter of 2006. The lower cash balance in the third quarter of 2006 reflects the year-to-date share repurchase cost of approximately \$825 million and a higher client receivable balance due to timing of payments. Our cash flow from operations was over \$360 million through the third quarter of 2006 compared to \$901.5 million through the third quarter of 2005.

This decline is a result of the timing of our billing cycles and growth and does not at all reflect the change in cash flow fundamentals. For example, by the end of the day on the Monday after our fiscal third-quarter close we collected over \$460 million from our clients. You may recall that we had the same cycle effect in the first quarter of 2006.

As we announced today, the share repurchase plan has been increased by \$1 billion, now bringing the plan total to \$2.5 billion. Share repurchases in the fourth quarter 2006 to date amount to 1.6 million shares at a cost of approximately \$90 million. We plan on continuing to repurchase shares under our repurchase program subject to internal guidelines and applicable legal restrictions.

Total debt amounted to approximately \$1.4 billion at the end of the quarter. We plan to pay down an additional \$200 million of debt as part of our accelerated debt paydown plan for 2006. For the first nine months of 2006 capital expenditures totaled \$87.8 million, an increase of \$10.4 million from the same period last year. We still expect no more than \$150 million for full year 2006.

In terms of guidance for 2006, we have raised and narrowed our diluted earnings per share expectations and now expect a range of \$2.33 to \$2.36, up from \$2.26 to \$2.35, excluding the effect of the onetime legal settlement charge of \$0.33 per share from the first quarter. This reflects anticipated growth of 27 to 28% when compared to 2005 results with estimated stock option expense included in both periods. This growth rate incorporates the 2005 pro forma stock option impact of \$0.21 per share. 2006 diluted EPS excluding the onetime legal charge and approximately \$0.36 per share in amortization of intangible assets that existed when Medco became a publicly traded company in 2003 is projected to be in the range of \$2.69 to \$2.72, up from \$2.62 to \$2.71.

For the full year 2006 we anticipate the following -- \$0.14 to \$0.16 per share on brand-name drug patent expiration, this was narrowed from the previously increased range of \$0.10 to \$0.16 from last quarter; Medicare EPS accretion of approximately \$0.04 per share; contribution from Accredo Health Group to be in the range of \$0.06 to \$0.08 per share for the full year, as I previously stated, we now expect 90 million mail-order prescriptions, a reduction of 1 million from our previous expectations. This reduction is primarily due to lower than anticipated mail utilization in newly installed clients; approximately \$0.13 per share in projected 2006 stock option expense associated with the Company's implementation of new stock option expensing rules on January 1, 2006, these expenses will continue to be charged approximately 80% to SG&A and 20% to cost of goods sold; \$0.03 per share in incremental year-over-year restricted stock unit expense.

We now expect SG&A expenses of approximately 960 to \$970 million including a full-year of Accredo SG&A, Medicare Part D expenses as well as stock option and RSU expenses. This range excludes the onetime legal charge. Consolidated amortization of intangible assets of approximately \$219 million including \$39 million in incremental intangible amortization associated with the Accredo acquisition and subsequent PSAI asset acquisition. Weighted average diluted shares now ranging from 300 to 305 million. And lastly an average tax rate for the full year 2006 of approximately 38%.

During the fourth quarter we typically see a slight increase in mail volume due to contemplated plan design changes. In addition, the fourth quarter will contain 13 weeks, not 14 weeks as it did in 2005. We also continue to expect approximately 10 to \$15 million in expenses related to the corporate integrity agreement implementation, our Medicare Part D program and new client installation costs. We also remind you of the higher Synagis revenue in the fourth quarter from Accredo Health Group which is a lower margin product.

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On October 23rd it was announced that the corporate integrity agreement was signed. A CIA is a standard document established when a party enters into a settlement that involves a program that falls within HHS' purview. As Dave mentioned, this closed our most significant long-standing legal issue. The settlement amount did not include compliance costs which will be expensed as incurred. We would underscore that our decision to settle was voluntary and the result of a mediation process initiated by the court. Although Medco did nothing wrong, settling these matters was the right business decision for our company and our clients.

Today we've introduced guidance for 2007. GAAP diluted earnings per share for full year 2007 are projected to be in the range of \$2.76 to \$2.83. This represents a growth in earnings per share of 17 to 21% over 2006 excluding the onetime legal settlement charge from the first quarter of 2006. Excluding the onetime legal settlement charge in 2006 and the amortization of intangibles from our spin-off, we anticipate growth of 15% to 19% over 2006 with a range of \$3.12 to \$3.19. We expect SG&A expenses to be in the range of \$1 billion to \$1.05 billion..

We also anticipate an annual tax rate ranging from 38 to 38.5% with an estimated weighted average diluted shares outstanding range of 295 to 300 million. We expect mail-order volume to be nearly 95 million for the full year. We look forward to a strong year end and we will update our guidance as necessary to reflect any changes in our assumptions. And I look forward to giving you more details around our 2007 guidance at our analyst day on November 30th. With that I'd like to turn the discussion back to Dave.

Dave Snow - Medco Health Solutions - Chairman and CEO

Thanks, JoAnn. I'd like to ask the operator to open the lines now for your questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Ricky Goldwasser, UBS.

Ricky Goldwasser - UBS - Analyst

Thank you for taking my question. Just a clarification on the SG&A, SG&A in the quarter was compared to historical levels. Is this level sustainable going forward and could you give us more color as to what drove the SG&A down?

JoAnn Reed - Medco Health Solutions - SVP, CFO

Yes, in terms of the guidance that we've given you for the full year for 2007, you know the amounts that we're expecting. So the level that we've given you for our full-year estimates are really the level that we expect. The reason that we're down slightly is primarily related to lower headcount in terms of open positions that have been filled, efficiencies that we have in terms of the operations where we've looked at better automation of our services. And then we have a slight benefit from some of the operational items in the quarter. So yes, it is sustainable and we believe we've given you the guidance for the full year.

Ricky Goldwasser - UBS - Analyst

And that's also reflected in '07 in terms of the better information (indiscernible)?

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JoAnn Reed - Medco Health Solutions - SVP, CFO

That's correct.

Ricky Goldwasser - UBS - Analyst

Thank you.

Operator

Charles Boorady, Citigroup.

Charles Boorady - Citigroup - Analyst

Good morning. The first question on the '07 guidance, are you able to bifurcate sort of how much of that growth you would attribute to overall growth in the industry that you expect verses any marketshare gains that you'd achieve?

Dave Snow - Medco Health Solutions - Chairman and CEO

We're going to go through, as we did last year, the more granular assumptions around the '07 landscape at our analyst day which will be webcast. So we'd like to give all those sorts of details at that time.

Charles Boorady - Citigroup - Analyst

Okay, great. Fair enough. And do you have any observations regarding recent events, M&A in the industry, vertical integration? Do you think that makes sense and how you think that will play out for you?

Dave Snow - Medco Health Solutions - Chairman and CEO

Obviously you're referring to the CVS Caremark announcement. And it's obviously brand-new, but I think my reaction to it -- I'm going to keep my comments limited. But first, I think, as you can see from our 2007 guidance today, we're confident in our business model as it stands. We have proven consistently that we'll deliver on the expectations that we provide to our investors and our strategy for growth is in place and we remain confident in our outlook for 2007.

I'd also point out that we do have a strong history of performance in this competitive environment. I don't think that's changed at all. From a client perspective our job as a PBM is to drive best value, it's not in our clients' best interest for us to be agnostic to mail or retail. We want to deliver savings. I think that there's some homework to be done around that announcement. It's not in our strategic plans today.

Charles Boorady - Citigroup - Analyst

I appreciate that. You came out of a vertically integrated situation when the Company was spun out of a manufacturer and it seems like the industry evolved to one where the independent PBMs have had an advantage and have gained share over models where the PBM was owned by somebody else in the value chain. Do you believe that holds true for the future or do you think there are changes on the horizon that might make the Company rethink that?

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Dave Snow - Medco Health Solutions - Chairman and CEO

I think that you have to think about your point. It's a valid point and I do think my comment earlier about -- very much in the announcement that we all heard tied to this recent competitive change, you heard the word agnostic over and over again. What that really means is you don't want to favor mail over retail because then consumers will love that. Well, to the extent the payer is paying the bill, that is not necessarily the right positioning, and I do think that is what I would call channel conflict.

So I think those are the things that people have to fully analyze and think about, and our position is that's something you need to be very thoughtful about before you make any moves in that direction.

Charles Boorady - Citigroup - Analyst

Thank you.

Operator

Lisa Gill, JPMorgan.

Lisa Gill - JPMorgan - Analyst

Good morning and thanks very much. You talked about the fact that you didn't anticipate that AWP would have much impact, Dave and JoAnn, but I am just wondering as we move beyond AWP, so let's say the settlement comes about, can you maybe talk about where you think contracting will do, what other type of benchmarks potentially could be used and what you think that means for the industry?

Then secondly, I just wanted to make sure I understood you, JoAnn, that when you said there were no other one-item items in the Q beyond the tax benefit you were talking about, any other potential rebate settlements or anything else; is that correct?

JoAnn Reed - Medco Health Solutions - SVP, CFO

To answer your second question first, Lisa, yes, that is correct. As I committed to do, I will tell of any nonrecurring items that we would have discussed in the Q on the call so that you are all aware of them. So I wanted to make sure you understood that there were no special revenue items that we would be including in the Q.

Lisa Gill - JPMorgan - Analyst

We appreciate that.

JoAnn Reed - Medco Health Solutions - SVP, CFO

Sure. Then in terms of changes to the benchmarks, there could be usage of many different benchmarks as we go forward. As I had originally spoke to all of you, starting about two years ago we were told by First Data Bank that they would be switching over to average benchmark price, and that is a measure now that we understand will not be utilized. So there are other benchmarks that are already out in the marketplace. And there is an average sales price benchmark, there is the AWP which we believe will be going away based on this settlements if it occurs.

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You could go to average manufacturer price, you could go to wholesale acquisition costs, and these are just benchmark prices as we have told you. And then what we would do in terms of the clients is readjust the discount to those in order to keep the economics similar to what they are today, utilizing the average wholesale price.

So what really matters to our clients and to us is that the ingredient cost that they are paying is consistent with the prices that they are paying today, and that is what we will utilize when we readjust the discount level.

Lisa Gill - JPMorgan - Analyst

So just so I understand this correctly, you believe that regardless of what the new benchmark is that PBMs and their clients believe that the relationship is fair and, therefore, you will be able to negotiate so that your economics remain the same regardless of what this new benchmark is; is that the correct way to think about this?

JoAnn Reed - Medco Health Solutions - SVP, CFO

I think, Lisa, that is the correct way to think about it from Medco. We have spoken -- as Dave said, he's spoken personally to over 150 clients based on this methodology change. But our clients are also well aware that average wholesale price usage is simply a benchmark from which we discount. And therefore we will continue to work with our clients as this benchmark may change, but I think they're well aware of the economics.

Lisa Gill - JPMorgan - Analyst

Great, thanks very much.

Operator

Larry Marsh, Lehman Brothers.

Larry Marsh - Lehman Brothers - Analyst

Thanks and good morning, everyone. Let me drill down a little bit if I could, Dave, on the specialty in Accredo. Could you elaborate a little bit about what the product mix that impacted you in Q3, because it seemed like historically we wouldn't have seen that in the September quarter? And then just a little bit of discussion about the decision of customers bringing the business in house and then I just had a quick follow-up from that.

Dave Snow - Medco Health Solutions - Chairman and CEO

Since we have Tim here with us today I'm going to ask him to field that one.

Tim Wentworth - Medco Health Solutions - CEO of Accredo

Good morning, Larry. It was not a surprise to us that at the very top-level you heard us reconfirm that we think we're going to hit the -- in fact, we're sure we're going to hit the \$0.06 to \$0.08 full accretion number for the year, it was what we expected. It was the result of a number of circumstances some of which will not reoccur -- most of which will not reoccur in fact in terms of some business shifts. As JoAnn mentioned, we had a couple of managed care contracts that began to do work themselves and we're getting the inflow of increasing Medco patients at a rate that was just a little slower than that on the high-value patients side.

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As you might appreciate, the patients that are the highest value we take the longest to bring into our system because of the services that they require. So we feel very comfortable with the full-year outlook and moving forward in terms of the mix. And in terms of your other question, I've spent a huge amount of my time with Medco's largest customers, all of whom are incredibly interested in partnering with our specialty pharmacy to move all their relevant patients into a much more narrow circumstance and really bring them straight over to Accredo. And we're working based on each plan's individual DNA as it were to do that.

So there are some plans that are moving to make mandatory changes in their plan designs, there are others that are using consumeristic sort of incentives to give their patient the strong incentive to come into the Accredo specialty pharmacy. And we're finding a huge amount of focus on that. We had several hundred clients in New York a couple of weeks ago who attended a breakout session on this, and it was just very clear that they want to get in front of this trend now working with us.

Dave Snow - Medco Health Solutions - Chairman and CEO

Let me add to that, Larry. We've talked a little bit in the past about a clinical strategy that includes Therapeutic Resource Centers, includes a relationship with Health Ways. Another reason additive to Tim's point that clients are listening and moving to our channel is tied in that clinical strategy and the therapeutic resource centers and some of the bigger things we could do. And I'm not going to go through it on the call, but I will tell you that on November 30th we're going to do a deep dive in that new innovation and you'll understand, I think, more fully why clients might be compelled to focus on the channel distribution.

Larry Marsh - Lehman Brothers - Analyst

That's great. And just a quick clarification on the PAL litigation based on Lisa's question. I guess if David Machlowitz is around -- are you in a position to comment on the process of the actual litigation given some of the plaintiffs' attorneys' claims and their attempt to certify the class or are you not commenting at all about that?

David Machlowitz - Medco Health Solutions - General Counsel

Well, the litigation status is that -- before the court for approval or disapproval or tweaking of the proposed settlement. And for those on the call not familiar with the term "PAL litigation", I guess everyone thinks of it as the AWP litigation if they haven't read the court papers. There may be some efforts to intervene in the suit by, for example, retail pharmacies which I think have a lot at stake in this matter and we'll see what happens. It's months away from a court decision on whether it would be approved or not and then would be further months away from being implemented. Does that address your question?

Larry Marsh - Lehman Brothers - Analyst

Yes, it sounds like at this stage it's hard to handicap the process from where you sit.

David Machlowitz - Medco Health Solutions - General Counsel

We are not now and never have been a party to the lawsuit, so we're not intimately involved in it. Obviously since it's caused so much stir or good or imaginary reasons we've been paying pretty close attention to it.

Larry Marsh - Lehman Brothers - Analyst

Okay, fair enough. Thanks.

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Operator

Tom Gallucci, Merrill Lynch.

Tom Gallucci - Merrill Lynch - Analyst

Just a couple of quick ones here. First, on next year's guidance, JoAnn, it looks like the share count that you're projecting is similar to what we have now. So should we expect that the share repurchase is offset by some natural increases to the share count, or have you not really factored much share repurchase into next year's guidance at this point?

JoAnn Reed - Medco Health Solutions - SVP, CFO

Your first assumption was correct, Tom, in that we expect that we will continue to repurchase our stock in the marketplace as we believe it's the fair value for our shareholders and we will have additional stock options that will be included in our fully diluted share count.

Tom Gallucci - Merrill Lynch - Analyst

Do you know the magnitude of the increase that you would have?

JoAnn Reed - Medco Health Solutions - SVP, CFO

We'll give you more color about that at analyst day.

Tom Gallucci - Merrill Lynch - Analyst

Okay. And then I just wanted to clarify one other thing, JoAnn, that you mentioned on the Medicare, the mail penetration. I think you said about 11% at this point and then you said another number later for next year, somewhere around 36% for your PDP. Are those two numbers comparable or is there a difference that I'm not catching?

JoAnn Reed - Medco Health Solutions - SVP, CFO

They're different numbers. What I was trying to do is highlight for you with the loss of dual eligibles our mail penetration rate actually increases significantly because the dual eligibles have no incentive to utilize mail. And with them being at a low 1%, we believe if you look at just the individual enrollees as well as those that are our group enrollees into our PDP, they have a lot higher mail penetration rate. So for 2006 overall we're expecting that higher mid 30% mail penetration.

Dave Snow - Medco Health Solutions - Chairman and CEO

Let me add to that, Tom, because it's an important point. The dual eligibles are among our most highly reimbursed from a premium standpoint because they have by definition lots of medical issues. The challenge is the dual eligible, because of their income status, literally has no skin in the game personally relative to where they buy the drugs, what type of drug it is whether it be brand or generic, they don't care about formulary, it's basically all contemplated and covered by a third party.

So as a result the typical managed care techniques you use to manage drug spend don't apply well to this population. So I think current stake today, if you just look within our PDP, the mix, you can see overall the average is 11%. But if you just sort out those that managed care can't really influence, you can see that those who do have some skin in the game really do make better

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purchasing choices and I think that's the point. And so, on a go-forward basis Medco is very focused on driving membership in the non-dual eligible category.

Tom Gallucci - Merrill Lynch - Analyst

Right. So you'll be allocating fewer dual's next year and by contrast it may lower your revenues, but it helps the quality of your mix it sounds like.

Dave Snow - Medco Health Solutions - Chairman and CEO

Exactly.

Tom Gallucci - Merrill Lynch - Analyst

Okay. And then just one other one. I guess just back on the AWP issue real quick. You mentioned 93% or so I guess on contracts that have sort of the provision in there and then, David, you've spoken to a lot of customers personally; so I guess the customers that you've spoken to, do they include a lot of the other 7% or how should we think about how that piece of the equation plays out? Thanks a lot.

Dave Snow - Medco Health Solutions - Chairman and CEO

I've spoken to basically people in almost every category of our business, so I've talked to health plans; I've talked with a large employer groups; I've talked to the middle market, the Systemed size accounts; I've talked to some labor and I've talked to some government accounts. And universally across the board the reaction after some education was very straightforward and it was not a difficult conversation whatsoever.

I think what JoAnn said in her comments -- I'm going to restate what she said. She said we have 93% in the contracts today, that remaining 7% is -- much of it's going to be negotiated between now and the time -- if FDB's settlement gets put into place, much of that will already be taken care of tied to the normal process of renewal.

Now remember, when we've talked about our planning for this because many of you have asked about this and we've talked publicly about our preparations for this, we always thought AWP would change in Jan. 1, 2008. So what this really has done is it's simply shortened the timeline by six months and by Jan. 1, 2008 we anticipate it having 100% done.

Tom Gallucci - Merrill Lynch - Analyst

Thank you.

Operator

Glen Santangelo, Credit Suisse.

Glen Santangelo - Credit Suisse - Analyst

Dave, just one more big picture question. You commented earlier in the call regarding your thoughts around vertical integration, but could you maybe just reflect for a second on the potential possibilities for other combinations within the PBM sector? And maybe as part of that, if you could maybe reflect on the Caremark Advance PCS merger from a few years ago and maybe how

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the FTC kind of views and analyzes or sizes up this market. And maybe talk about what might and might not be acceptable from an FTC perspective?

Dave Snow - Medco Health Solutions - Chairman and CEO

That's a good question. My view right now, and I will defer to counsel to correct me if he doesn't agree, but my view is that the FTC is looking at more competitors in this market today than there were three years ago. You're seeing retail get more heavily involved in the PBM space. You're seeing health plans get more involved in the PBM space. And so -- and I also think that Medicare Part D brought in a whole bunch of startup players to go up directly after that Medicare population and there are some brand-new players that didn't even exist three years ago.

So I believe as the FTC looks at this bigger market they're seeing more competition and I don't think that the numbers would say there's any problem with a proposed combination like the one you heard. My view also is because of the nature of this industry my belief is Medco is by far the best asset, by far, in the space. And as I've said many times, we're very comfortable with the way we're approaching this.

But I think clearly this whole thing will be watched and I think it will make health plans think. I think it will make retail think and it's going to be an interesting time. And I think frankly a company like Medco is in a very good position relative to these dynamics and it will create opportunity in many different ways. So we're excited about it actually.

Glen Santangelo - Credit Suisse - Analyst

Thanks for the comments. And just one follow-up for JoAnn. This number may be in the Q that you're going to publish, but can give us a sense for if there's a significant amount of share repurchase maybe post the quarter end? Can you give us a number up to today or is that not allowed?

JoAnn Reed - Medco Health Solutions - SVP, CFO

No, I actually commented on that in my script, so let me give you the fourth quarter. We have repurchased -- fourth quarter we repurchased 1.6 million shares at a cost of \$90 million and that was through yesterday's close.

Glen Santangelo - Credit Suisse - Analyst

Okay, thank you very much for the comments.

Operator

Christopher McFadden, Goldman Sachs.

Christopher McFadden - Goldman Sachs - Analyst

Congratulations on the nice results. Dave, I'm interested in your experience, when you have in the past seen a competitor go through some type of business combination or other sort of change dynamic, has that historically been something that has affected your win rate when you thought about your contracting activities with commercial plans or employers? And in the context of that as we sit here in early November how much into the selling season do you think that you are in terms of the total opportunity you saw for this selling season, how much on that business has been closed?

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Dave Snow - Medco Health Solutions - Chairman and CEO

Obviously you've seen in the past combinations like -- it really depends on the combination, Chris. If the combination is extremely well communicated and executed it may not create a real play opportunity in the short-term. On the other hand, these often do create concerns and instability which are opportunity. I think that will just have to play itself out. I'm hopeful that we will see opportunities that arise because of this. I think that in terms of our selling season for 2007 into Jan. 1, 2008, this certainly is going to perhaps give us some prospects we hadn't planned on. But beyond that I just don't know, it's too soon to say.

Christopher McFadden - Goldman Sachs - Analyst

And how much of the selling season in aggregate would you estimate is sort of still out there to be confirmed one way or the other?

Dave Snow - Medco Health Solutions - Chairman and CEO

I'm not going to give a hard number, but we have a lot of activity going on right now, an awful lot of activity.

JoAnn Reed - Medco Health Solutions - SVP, CFO

And remember, Chris, from the last combination that we saw, even if deals are closed for 2007 or 2008 at this point in time, there are contracts that do include a change of control provisions that would allow additional opportunity for us.

Dave Snow - Medco Health Solutions - Chairman and CEO

And we don't have our hands around that at this point, Chris.

Christopher McFadden - Goldman Sachs - Analyst

I understand. And then a follow-up too and kind of a detail question. So can you just walk me through the factors that contributed to your net interest expense in the quarter? I understand your comments in your prepared remarks that the nature of your business is sometimes lumpy cash flows from period end to period beginning. But yet it seems like here the sequential increase in interest expense was a little bit higher than we had modeled and I'm just wondering if there was any sort of color you can shed on what factors might have contributed to that?

JoAnn Reed - Medco Health Solutions - SVP, CFO

In terms of the third quarter, our interest expense itself, the rate was 6.5%. So that may have been higher than you had originally contemplated. And then we had the additional drawdown in terms of our AR facility because of the additional cash flow that was required for working capital as well as the incremental debt that we have outstanding from the Accredo acquisition. So it was really the combination of those three things that played into the interest expense with the cash balances being lower.

And as you probably heard on (indiscernible) call, he did cite the fact that their payables were improved in the third quarter because of a late payment to Medco. So that was really primarily the biggest piece of the over \$400 million that I talked about that we received on that Monday.

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Christopher McFadden - *Goldman Sachs - Analyst*

And that 6.5% rate, is that a function of market conditions and therefore sort of a new modeling assumption or is something about just the rate in the quarter that is perhaps transitory?

JoAnn Reed - *Medco Health Solutions - SVP, CFO*

No, that's based on where the interest rates are today. So it's 6.5% for the third quarter and 6.2% for the nine months. So you can see that the interest rates are going up slightly as we went through the year.

Christopher McFadden - *Goldman Sachs - Analyst*

Very good. And then finally just from an overall -- you talked about efficiency on the SG&A side. Can give us a sense of total headcount, round numbers, today versus where you started 2006?

JoAnn Reed - *Medco Health Solutions - SVP, CFO*

We don't really give our headcount numbers on a quarter-by-quarter basis, but we did see higher turnover in terms of the third quarter in terms of headcount as well as we had shifted some of our headcount for our software developers from employees as they turned over to consultants to help us get through the year-end requirements.

So I would say it's really a combination of both of those types of things. You will see in the fourth quarter though that we will increase our staffing as we're getting ready for this significant number of new clients that we've already sold in for 1-1-2007. So that number kind of changes depending on the market dynamics.

Christopher McFadden - *Goldman Sachs - Analyst*

Thank you for the detail.

Operator

Robert Willoughby, Banc of America Securities.

Robert Willoughby - *Banc of American Securities - Analyst*

JoAnn, what is the timing on the receivable? I guess there's a \$202 million receivable from the government coming in. Is that a fourth-quarter phenomenon or is that some time in '07 do you think?

JoAnn Reed - *Medco Health Solutions - SVP, CFO*

We're hoping that we'll be able to see it in the fourth quarter. It may flip over to the first quarter of 2007 by the time all of the reporting requirements are finalized.

Robert Willoughby - *Banc of American Securities - Analyst*

Okay. And just looking at -- with so many blockbusters that came off patent I would have thought inventories would have ticked down sequentially; any reasons why they would build?

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JoAnn Reed - Medco Health Solutions - SVP, CFO

We always build our inventories for the fourth quarter. As you are aware, mail service volume ticks up in the fourth quarter because of plan design changes and as people believe that they'll be impacted because of their co-pays. Particularly at mail service we contemplate the higher volume. We also get prepared for the first quarter with the new business that we're adding and the mail penetration rate on that business is well over 30%. So we're doing that as well as our normal inventory planning.

Robert Willoughby - Banc of American Securities - Analyst

Was Zocor not a product you bought direct from the manufacturer though? I would have thought we'd see some benefit there.

JoAnn Reed - Medco Health Solutions - SVP, CFO

We don't comment on individual products and where we acquire the product. As you know, we have a handful of manufacturers on the branded side where we buy directly from the manufacturer. 60% of our overall inventory volume though does come through our distributor.

Robert Willoughby - Banc of American Securities - Analyst

Right. Okay, thank you.

Operator

Andy Speller, A.G. Edwards.

Andy Speller - A.G. Edwards - Analyst

I've got two around the consumer if I could. There's a lot of talk about being vertically integrated around consumer driven issues. Dave, to your comments earlier, you make it sound like there is no pressure really at the payer to have a major consumer initiative. And are the PBM's in their current form able to take the additional consumer driven type methods? And then also around Medicare, as you guys are into this, the dual's -- I mean, are they incrementally profitable to what you do on the Medicare Part D side and do you need them on a go forward basis?

Dave Snow - Medco Health Solutions - Chairman and CEO

Good questions. On the consumer driven front we're going phenomenally well relative to our sell-ins of our consumer-driven health plan products. On the Medicare Part D side we've done very well relative to sell-ins of our PDP without any advertising. I do think that what you're referring to is a need for a business-to-consumer brand over time in the Medicare Part D and perhaps consumer driven base space generally. And there are many ways to achieve a consumer brand so we're very aware of it and there are many ways to solve for it so we're comfortable with that.

It isn't wrong to think about a business-to-consumer brand because clearly PBM's historically have been known as business-to-business companies. And so we too have our own approach and strategy around that. So that's going to continue to evolve and there are many solutions. But I think it's very important as we develop those solutions we don't in some way run afoul of the major payer here who is not the consumer; it is the employer. And choice is wonderful at the member level, but making certain you optimize every dollar spent is the payer's interest, that's our employers, our health plan. And we don't want to be in the position where we're not trusted relative to doing what's best for our clients.

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So that's the concern you have to deal with as you move to create a consumer brand and make things wonderful in an agnostic way at the consumer level. When it comes to dual's, they're breakeven. Obviously they do contribute to fixed overhead. But relative to profitability the premium is big enough to handle the real medical expense at the real drug expenses. And as I mentioned earlier, you really can't move them to make them more efficient in their choices because of the nature of their contribution and the incentive for them to be prudent buyers of drugs.

Andy Speller - A.G. Edwards - Analyst

Thank you.

Dave Snow - Medco Health Solutions - Chairman and CEO

JoAnn, do you want to add something to that?

JoAnn Reed - Medco Health Solutions - SVP, CFO

I wanted to clarify because when Bob Willoughby asked the question about the government, I thought you were talking about the CMS receivable related to the risk corridor. And there could be a reason that you were talking about the tax receivable. In our balance sheet you can see that we have classified the tax receivable as a long-term asset and we wouldn't expect to see reimbursement for that before 12 months out.

Operator

Mike Maguire, FTN Midwest.

Mike Maguire - FTN Midwest - Analyst

Just a broad question, David, on 2008 through 2010 what changes in this model with regards to competition, Part D -- just kind of curious your thoughts on your growth prospects beyond '07. I know you can't touch guidance, but if you're potentially on the back end of a generic cycle, you referred to increasing competition and potentially Part D maybe with employers not accepting the subsidy going forward. Just your sense how you feel about the growth prospects beyond '07.

Dave Snow - Medco Health Solutions - Chairman and CEO

I feel very strongly that our prospects are great and there are number of reasons for that. I think that the opportunity to win new business, and I'm not going to speak to where it comes from, but it is very strong so long as you're continuing to innovate and drive value to customers. You're going to hear more about our most recent innovation at our November 30th analyst day. I believe that this new innovation sets absolutely a new standard in the practice of pharmacy that will bring enormous value to our customers both on the drug management side as well as the medical side of the business.

I do believe that the generic run clearly goes through 2010. Don't forget that there are other drugs after out there after 2010 and actually the number one drug in the world, Lipitor, is out there in 2011. So that will continue. Specialty growth is enormous. The ability to meet individual member needs to the extent they're individually choosing is important. We have a lot of large health plan customers that we work with to address those needs and I don't see that changing.

So I think taking share and doing the fundamentals and creating better and better value propositions that stay ahead of our competitors will continue to drive our growth beyond just generics. And again, as I said, generics are strong through 2011 and

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even beyond that. I also think that there's going to be an opportunity by the time we get to 2010 or sooner that there's going to be something that's the generic equivalent for the biotech drugs. Henry Waxman has a bill out there right now, it's in its initial stages. But I do believe that the longer -- that that will get refined and that we as a country will define what a generic is in the biotech space.

There are a number of drugs today in the biotech space that have already exceeded their patent expiration dates. The problem is there's no way to create a generic because a roadmap hasn't been defined. So that's a brand-new opportunity that's developing. I gave a speech down in Washington a couple of weeks ago to a Medicare group -- a fairly large group, the Third National Medicare Congress, and I actually put a slide together that just shows Dave Snow's view of the world, not necessarily Medco's, but Dave Snow's views of the world in terms of how I believe the evolution will occur around people, employers getting out of the business and moving from BtoB to BtoC in Medicare. It's a very, very gradual process. It's not a revolutionary process.

PDP's and employer sponsorship will continue to grow. MAPD's will also grow. Other pieces will shrink, but we're going to go into at our November 30th conference kind of what we see the world evolving to and how we're going to deal with it in Medicare. So I hope that answers your question.

Mike Maguire - *FTN Midwest - Analyst*

It does, thank you.

Valerie Haertel - *Medco Health Solutions - VP of IR*

I think, operator, we probably have time for one more question.

Operator

Michael Baker, Raymond James.

Michael Baker - *Raymond James - Analyst*

With the majority of the selling season kind of behind you now, can you give us a sense of whether the theme was the key theme kind of being priced or serviced and whether you kind of saw any meaningful changes in share?

Dave Snow - *Medco Health Solutions - Chairman and CEO*

Obviously in 2006 from everything I've seen and read we are the number one net new growth company in the PBM space. It was a great selling year in my opinion. And the competition, as I've said before, was not -- obviously price is the ticket to entry. You've got to have the scale and you have to be able to compete on a price basis, but the pricing has been stable throughout the year. And so how is business won or lost? It's about the additional value you can bring to a client in addition to price.

And obviously we started talking to you about this in 2003, but every year we've introduced new innovations that have been measurable in terms of value to clients and it is helping us be a leader relative to the net new win situation. So we're feeling very good about it and I do look forward to revealing to you in some detail our newest innovation which will be hitting (technical difficulty) in our clients in 2007 which we spent all of this year building.

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Michael Baker - *Raymond James - Analyst*

Thanks.

Dave Snow - *Medco Health Solutions - Chairman and CEO*

You're welcome. Thanks again, everybody. I do appreciate your questions and I appreciate the large attendance we have today. As you can tell, we're enthusiastic about our prospects for the remainder of 2006 and the full year 2007. We'll further elaborate on Medco's strategies and innovative plans at our third annual analyst day on November 30th in New York City which will be webcast live. If you are interested, please contact Investor Relations. As always, we appreciate your interest and participation and have a great day.

Operator

Ladies and gentlemen, that concludes the Medco Health Solutions third-quarter 2006 earnings conference call. We appreciate your time. You may now disconnect.

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